Supreme Court, U.S.
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No.

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1995

SHELDON AND ANITA DROBNY, *pro se*,

Petitioners,

vs.

THE UNITED STATES,

Respondent.

Petition for Writ of Certiorari to the
United States Court of Appeals
For the Federal Circuit

PETITION FOR WRIT OF CERTIORARI

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(1a) QUESTIONS PRESENTED

1. Whether petitioners were improperly denied income tax refunds when their claimed depreciation deductions, investment tax credits, and energy tax credits were disallowed, with respect to disputed investments in "leveraged leasing" of solar energy equipment; more specifically:

A. Does the absence of third party financing preclude a transaction from being treated as a legitimate leveraged lease?

B. Was the disputed transaction a "sham" on grounds it had no practical economic effects because no reasonable profit motive existed?

C. Were petitioners improperly lumped together with other claimants,

where specific facts pertaining to the "sham" criteria were significantly different as to them than as to the other investors?

2. Where a decision from another Circuit on facts functionally indistinguishable from the case at bar, Sacks v. Commissioner, 69 F.3d 982 (9 Cir. 1995), reversed the Tax Court and ruled in favor of the taxpayer, is due process of law, guaranteed by the 5th Amendment, violated here when the reviewing court, in order to rule against the Drobnys, drew spurious factual distinctions, thereby ostensibly avoiding a conflict between the Circuits, and thus diminishing Drobnys chances to obtain a writ of certiorari?

3. Is the constitutional mandate of

separation of powers violated when the IRS, the Court of Claims and the Court of Appeals for the Federal Circuit, impose conditions on business practices that render the disputed transaction a "sham," despite the intent of Congress to encourage use of energy alternatives through the very tax advantages that petitioners sought to employ?

(1b) PARTIES INVOLVED (per Rule 21.1(b)]

Petitioners, Sheldon Drobny and Anita Drobny, were Plaintiffs in the Court of Federal Claims, and Appellants in the United States Court of Appeals for the Federal Circuit.

Respondent, The United States, was the defendant in the Court of Claims, and appellee in the Court of Appeals.

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credits were disallowed, with respect to disputed investments in "leveraged leasing" of solar energy equipment; more specifically:

A. The absence of third party financing does not preclude a transaction from being treated as a legitimate leveraged lease;

B. The disputed transaction was not a "sham," in that it had practical economic effects, and a reasonable profit motive existed;

C. Petitioners were improperly lumped together with other claimants, where specific facts pertaining to the "sham" criteria were significantly different as to them than as to the other investors.

2. Since a decision from another Circuit on facts functionally indistinguishable from the case at bar, Sacks v. Commissioner, 69 F.3d 982 (9 Cir. 1995), reversed the Tax Court and ruled in favor of the taxpayer, due process of law, guaranteed by the 5th Amendment, is violated here when the reviewing court, in order to rule against the Drobnys, drew spurious factual distinctions, thereby ostensibly avoiding a conflict between the Circuits, and thus diminishing Drobnys chances to obtain a writ of certiorari.

3. The constitutional mandate of

separation of powers is violated when the IRS, the Court of Claims and the Court of Appeals for the Federal Circuit, impose conditions on business practices that render the disputed transaction a "sham," despite the intent of Congress to encourage use of energy alternatives through the very tax advantages that petitioners sought to employ.

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IN THE
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---

PETITION FOR WRIT OF CERTIORARI

Petitioners, Sheldon and Anita Drobny, *pro se* (hereafter, plaintiffs, or the Drobnys), pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Federal Circuit, affirming the judgment of the United States Court of Federal Claims disallowing their claims

for depreciation deductions, investment tax credits, and energy tax credits denied by the Internal Revenue Service.

Judgment and Opinion Below

The Decision of the United States Court of Appeals for the Federal Circuit, affirming the Opinion of the Court of Federal Claims, denying Plaintiffs' claims, is set out as App. A. (App. 1) The Decision is not reported.

Jurisdictional Statement

On April 10, 1996, the U.S. Court of Appeals for the Federal Circuit filed its Decision (App. A; App. 1) affirming the judgment of the Court of Federal Claims. (App. C; App. 11; reported as Johnson v. United States, 32 Fed. Cl. 709 (1995).) Petition for rehearing was

denied on May 29, 1996. (App. B; App. 9)

This Petition for Certiorari is timely filed within 90 days thereafter.

Jurisdiction is invoked under 28 U.S.C. § 1254(1) and Rules 10(a) & (c), 12.1, and 13.1 of this Court.

Constitutional Provision

The Fifth Amendment to the United States Constitution provides, in pertinent part:

> "No person shall . . . be deprived of life, liberty or property, without due process of law . . . ."

Statutes and Rules Involved

Treas. Reg. § 1.183-2.

Rev. Proc. 75-21.

STATEMENT OF THE CASE

The Court of Federal Claims denied Plaintiffs' claims for depreciation deductions, investment tax credits and

energy tax credits denied by the IRS (App. C; App. 11), and the Court of Appeals for the Federal Circuit affirmed. (App. A; App. 1)

Plaintiffs' claim was adjudicated in the Claims Court together those of five other claimants, none of whom pursued an appeal in the Court of Appeals. Thus, while the Claims Court Opinion makes many statements concerning "Plaintiffs," in some crucial instances, in applying Treas. Reg. 1-183-2(b), it expressly excepts the Drobnys. (App. 40 - unlike other plaintiffs, did not rely on expertise of others, per factor #2; App. 41 - unlike other plaintiffs, did devote time to finding end users, per factor # 3.) And the Court of Appeals uniformly adopted and accepted ALL the

Claims Court's findings and conclusions as to ALL plaintiffs, without specifically considering the Drobnys' distinguishable situation.

The basis for federal jurisdiction in the court of first instance is 28 U.S.C. § 1491(a)(1) - U.S. Court of Federal Claims has jurisdiction over [*inter alia*] claims against the United States founded on any Act of Congress or any regulation of an executive department. The Court of Appeals for the Federal Circuit has exclusive jurisdiction of appeals from the Federal Claims court. 28 U.S.C. § 1295(a)(3).

Statement of Facts The facts are fully set out in the Court of Federal Claims Opinion, in summary at App. 12-25 and in detail (Findings of Fact) at App.

59-103. We do not repeat them in detail here. In summary, the facts material to resolution of the issues raised in this Petition are:

The Court disallowed deductions and credits which Plaintiffs claimed arose via a solar energy investment program that was active from 1981 through 1985, in tax years 1982-1985.

The Claims Court found, and the Court of Appeals agreed, that the alleged leveraged leases of solar energy equipment via the Solargistics-Geodesco program - by virtue of which investment and leasing program Plaintiffs claimed the disputed deductions and credits - was a "sham" because the transaction lacked economic substance, in that plaintiffs lacked a profit motive and

because an objectively reasonable possibility of making a profit did not exist. In so determining, the Claims Court made explicit findings of fact from which it expressly **excepted** the Drobnys. (App. 40-41; see p. 4, supra.)

Moreover, in concluding that the transaction/program did not qualify as a leveraged lease for tax purposes, the courts both relied on the investors' option to select nonrecourse financing. (App. 7, 84) However, the Drobnys did not exercise that option, and were personally liable - that is, with, not without, recourse. (Pl. Tr. Exh. 8A at p. 1)

The courts found that profits were not the primary concern of the investors, and that the Drobnys failed

to prove the existence of a profit motive. (App. 7-8, 45)

The Appeals Court affirmed without independently applying the appropriate standards to the evidence, as it relates to the Drobnys. (See App. 6-8.)

REASONS FOR GRANTING CERTIORARI

Prefatory Statement

Important, far-reaching and frequently occurring tax issues respecting leveraged leases of solar energy equipment, pivotal to the instant decision, were improperly decided in this case in the Court of Claims and the Court of Appeals for the Federal Circuit.

Congress has expressly sought to encourage the use of alternate energy sources, such as solar energy equipment as at bar, by providing strong financial incentives for their use.[1] See

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[1] "Congress sought, in the 1977 energy package, of which the solar tax credits were a part, to increase the use of solar energy in U.S. homes and businesses." Sacks v. Commissioner, 69 F.3d 982, 992 (9 Cir. 1995).

historical discussion, and analysis of why an investor's tax motive must not be used as grounds for denying tax benefits, in Sacks v. Commissioner, 69 F.3d 982 (9 Cir. 1995) (synopsized infra, pp. 14-15, 18-25.)[2]

Because this Court has not yet addressed the vital tax issues which are [we submit, erroneously] resolved in the

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[2] Most notably:

> "If the government treats tax-advantaged transactions as shams **unless** they make economic sense on a pre-tax basis, then **it takes away with the executive hand what it gives with the legislative. . . . The tax credits were** intended to generate investments **in alternative energy technologies** that would not otherwise be made because of their low profitability. See H.R.Rep. No. 496 at 8304. Yet the Commissioner in ... [Sacks] proposes to **use the reason Congress created the tax benefits as a ground for denying them.**" (Emphasis added.) Sacks, 69 F.3d at 992.

present case, in conflict with the 9th Circuit in Sacks v. Commissoner, supra - despite the Court of Appeals' attempt in Drobnys' case to misconstrue the facts so as to camouflage the actual conflict - certiorari is extremely appropriate.

This Court has often recognized the need for uniformity in the resolution of important tax issues, granting review in such cases as U.S. v. Donross Co., 393 U.S. 297 (1969) (degree of purpose necessary for application of accumulated earnings tax), Malat v. Riddell, 383 U.S. 569 (1966) (excluding from capital assets, property held "primarily" for sale), Millinery Center Bldg. Corp. v. C.I.R., 350 U.S. 456 (1956) (deductibility of business expenses in computing excess profits tax), Haynes v.

U.S., 353 U.S. 81 (1957) (whether disability payments by employers under similar plans were subject to federal income tax), Turnbow v. C.I.R., 368 U.S. 337 (1961) (to resolve conflict on matter important to proper interpretation and uniform application of Internal Revenue Laws).

Here, the apparent absence of a conflict between the instant decision and Sacks, which ordinarily would militate against a grant of certiorari, is actually produced by the courts' misconstruction of the facts at bar. In reality, there are no functional differences between this case and Sacks.[3] That having been said,

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[3] It should be noted that the Claims Court cited and relied on the lower court decision in Sacks (see App.

consider our **ARGUMENT**:

1. Petitioners were improperly denied income tax refunds when their claimed depreciation deductions, investment tax credits, and energy tax credits were disallowed, with respect to disputed investments in "leveraged leasing" of solar energy equipment; more specifically:

A. The absence of third party financing does not preclude a transaction from being treated as a legitimate leveraged lease;

B. The disputed transaction was not a "sham," in that it had practical economic effects, and a reasonable profit motive existed on Drobnys' part;

C. Petitioners were improperly lumped together with other claimants, where specific facts pertaining to the "sham" criteria were significantly different as to them than as to the other investors.

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29), which was subsequently overturned by the 9th Circuit opinion. Thus, while the Appeals Court overtly considered the Sacks 9th Circuit opinion, the Claims Court Decision in the present case considered only the overruled Tax Court decision in Sacks.

2. Since a decision from another Circuit on facts functionally indistinguishable from the case at bar, Sacks v. Commissioner, 69 F.3d 982 (9 Cir. 1995), reversed the Tax Court and ruled in favor of the taxpayer, due process of law, guaranteed by the 5th Amendment, is violated here when the reviewing court, in order to rule against the Drobnys, drew spurious factual distinctions, thereby ostensibly avoiding a conflict between the Circuits, and thus diminishing Drobnys chances to obtain a writ of certiorari.

3. The constitutional mandate of separation of powers is violated when the IRS, the Court of Claims and the Court of Appeals for the Federal Circuit, impose conditions on business practices that render the disputed transaction a "sham," despite the intent of Congress to encourage use of energy alternatives through the very tax advantages that petitioners sought to employ.

Certiorari should therefore be allowed.

As the 9th Circuit explained in Sacks,

> "Congress passed a package of tax and other laws to encourage people to invest in windmills, solar energy, geothermal energy, and

> other alternative energy sources, and to discourage 'gas guzzler' automobiles and other petroleum consumption. *See, e.g.*, 26 U.S.C. §§ 44C, 44D, 44E, 46(a)(2)(C); S.Rep. No. 95-442, 95th Cong. 2nd Sess., 1978 U.S.C.C.A.N. pp. 7855, 7903; H.R.Rep. No. 95-543." 69 F.3d at 984.

Here, despite that there was an option for non-recourse financing, the Drobnys did not exercise that option, and thus were personally liable on the notes. (Pl. Tr. Exh. 8A at p. 1; see Drobny's Reply Br. in Court of Appeals, p. 12.) Considering this, along with the Drobnys' profit motive - which even the Claims Court recognized (App. 38-39) - the ruling against them is at cross-purposes with all the existing legislation, regulations, and judicial decisions.

In determining that the

transactions were "sham" and not legitimate, leveraged leases, the Claims Court relied on a Department of Commerce Publication defining a leveraged lease. (App. 21, relying on BUREAU OF DOMESTIC COMMERCE, U.S. DEPT. OF COMMERCE, EQUIPMENT LEASING AND RENTAL INDUSTRIES: TRENDS AND PROSPECTS 26 (1976).) Based on this definition of a "typical" leveraged lease - which lacks the force of law, is merely advisory, and is not promulgated by Congress, the Treasury Department, or the IRS as a definition applicable in the federal tax context - the court concluded that (i) the absence of third party as the source of financing, (ii) the attenuated course of money - from end user to installer to Geodesco [the leasing company] to investor, of money

needed to recoup the original cash investment and payment of the obligation to the lender; and (iii) Solargistics acting as both manufacturer and lender, and Geodesco's multiple functions as lessee - prevented the plan in this case from being regarded as a legitimate leveraged lease.

Defendant did not contest Plaintiffs' argument that the program could have applied for, and would have received, a private letter ruling under Rev. Proc 75-21 that would have recognized the transactions as leveraged leases (App. 28), and concedes that the Plaintiffs owned the components they bought. (App. 29)

With regard to the lack of profit motive issue, based on which the courts

deemed the activity a "sham" (App. 7-8, 45), the Claims Court applied a non-exhaustive list of 9 factors found in Treas. Reg. § 1.183-2(b). (App. 39-44) While finding that "The motivation of the principal officers that promoted the Solargistics-Geodesco investment program clearly was profit oriented," (App. 38-39), the Claims Court stated that the Regulation's criteria are not a test of those motives, and analysis thereof "is not transferrable to the plaintiffs." (App. 39) Yet in so doing, the Court has ignored the controlling fact that Drobny, though a principal officer - and thus, in the view of the Claims Court, a person with profit oriented motivation - was also a plaintiff-investor.

In Sacks, the 9th Circuit relied on

Frank Lyon Co. v. U.S., 435 U.S. 561 (1978), which had expressly rejected the proposition that the investor's tax motive furnished grounds for disallowing the tax benefits:

> "The fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction. *See Commissioner of Internal Revenue v. Brown*, 380 U.S. 563, 579-80 . . . (Harlan, J. Concurring)."

Frank Lyon, 435 U.S. at 580, quoting from Justice Harlan's concurring opinion in Brown, as quoted in Sacks, 69 F.3d at 987. The Sacks Court continued:

> "[T]axes are part of the environment for every business transaction, so tax consequences are legitimately considered in genuine transactions:
>
> > * * * [T]he tax laws exist as an economic reality in the

> businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source.

Commissioner v. Brown, 380 U.S. 563, 579-80 . . . (Harlan, J., concurring)." Sacks, 69 F.3d at 987.

In assessing whether a transaction or plan is a "sham," in Sacks the Court stated:

> "[w]e typically focus on the subjective aspect of whether the taxpayer intended to do anything other than acquire tax deductions, and the objective aspect of whether the transaction had any economic substance other than creation of tax benefits." Ibid.

It should be noted that in Sacks, as at bar, there was lacking an independent third party creditor, the claimant's payments on the notes would be covered by the anticipated rental payments for the solar energy equipment, and the

payments were owed to the seller rather than an independent third party. See id. at 989. Similarly, as at bar where the courts found that the individual investors were not "hands-on" involved in the leasing and placement of the equipment, so, too, was Mr. Sacks not thus involved. Still, no sham. Ibid.

And as at bar (see App. 50, 102), the trial court in Sacks "went through a cash flow analysis to show that Mr. Sacks would be unlikely to make money from his solar water heaters, but for the tax benefits." Id. at 990.[4] Even

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[4] Moreover, the Drobnys did not give up all the economics and attempt to derive solely the tax benefits. Nor did they attempt to create tax benefits which did not otherwise exist. Instead, they purchased the equipment on fair terms, at fair market value. The lease agreement gave the Drobnys a fair return as well, substantially greater than in

this, held the 9th Circuit, did not render the transaction a "sham." Id. at 990-91. In language equally applicable at bar, the Court stated:

> "Mr. Sacks' investment did not become a sham just because its profitability was based on after-tax instead of pre-tax projections. It is undisputed that he stood to make money on an after-tax basis. 'The fact that favorable tax consequences were taken into account ... is no reason for disallowing those consequences.' *Frank Lyon*, 435 U.S. at 580 ... Where a transaction has economic substance, it does not become a sham merely because it is likely to be unprofitable on a pre-tax basis." Sacks, id. at 991.

And finally, the Sacks Court's analysis of Congressional motivation illuminates why the present decision is against public policy, in violation of

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Sacks, which lease terms afforded no profit to Sacks. Indeed, the Drobnys' lease agreement gave them a 125% return, in contrast to Sacks.

the constitutional separation of powers[5] doctrine.

> "Absence of pre-tax profitability does not show 'whether the transaction had economic substance beyond the creation of tax benefits,' ... where Congress has purposely used tax incentives to changes investors' conduct. Congress ... purposely skewed the neutrality of the tax system, even more than the usual tax credits and accelerated depreciation designed to encourage more investment in capital goods than would otherwise be made, because they sought to induce people to invest in solar energy. The House Committee on Ways and Means stated:
>
> > the committee recognizes that solar and wind energy equipment technology is presently at an early stage of commercialization. In view of this, the committee

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[5] Moreover, the court's reliance on the Dept. of Commerce publication as definitive in this tax context (App. 21; see p. 16, supra), amounts to a discrete violation of the principle that government branches are not intertwined so as to permit Commerce Dept. criteria to control in the tax setting.

> feels that there is a need to encourage the purchase and installation of this equipment. Thus, the committee decided to provide a credit for a limited number of years in order to accelerate the purchase and installation of this equipment and the development of solar and wind energy technology.
>
> H.R.Rep. No. 496(III), 95th Cong., 1st Sess 1977, 1978 U.S.C.C.A.N. pp. 817, 8304, 8335-36. The larger the tax advantage of a particular kind of investment, the greater the difference between before tax and after tax profitability is likely to be." Sacks, 69 F.3d at 991-92.

Then, comes the final part of the Sacks analysis, that shows precisely why this Court should take the Drobnys case - to determine whether the present decision can be permitted to stand in light of the (mis)construction of the statutory tax benefits in derogation of their very purpose:

> "If the government treats tax-advantaged transactions as shams

unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative. A tax advantage such as Congress awarded for alternative energy investments is intended to induce investments which otherwise would not have been made. Congress sought, in the 1977 energy package, of which the solar tax credits were a part, to increase the use of solar energy in U.S. homes and businesses. H.R. Rep. No 95-5434, 95th Cong. 1st Sess., 1978 U.S.C.C.A.N. 7673, 7768 ...

If the Commissioner were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them. The tax credits were intended to generate investments in alternative energy technologies that would not otherwise be made because of their low profitability. See H.R.Rep. No. 496 at 8304. Yet the Commissioner in this case at bar proposes to use the reason Congress created the tax benefits as a ground for denying them. That violates the principle that statutes ought to be construed in light of their purpose. *Cabell v. Markham*, 148 F.2d 737 (2d Cir.1945)

(L. Hand., J.)." (Emphases added.) 69 F.3d at 992.

We have quoted at length from Sacks to pique Your Honors' interest in the serious problem created by the present decision in the light of the reasons underlying the Sacks holding. We submit the 9th Circuit's exposition of Congressional purpose, together with its simple statement of the inexorable illogic of denying the benefits when the tax incentives induce exactly what Congress intended, is our best argument to convince this Court to take the Drobnys' case.

CONCLUSION

For the foregoing reasons, certiorari should be allowed; and, on the merits, the judgment adverse to Petitioners should be reversed.

Respectfully submitted,

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Petitioners, *pro se*

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APPENDICES

NOTE: Pursuant to Fed. Cir. R. 47.6, this disposition is not citable as precedent. It is a public record. The disposition will appear in tables published periodically.

United States Court of Appeals
for the Federal Circuit

95-5084

SHELDON and ANITA DROBNY,

Plaintiffs-Appellants,

v.

THE UNITED STATES,

Defendant-Appellee.

DECIDED: April 10, 1996

Before NEWMAN, LOURIE, and SCHALL, Circuit Judges

LOURIE, Circuit Judge

DECISION

Sheldon and Anita Drobny appeal from a decision of the Court of Federal Claims dismissing their claim for a tax

refund based on various deductions and tax credits denied by the Internal Revenue Service. Johnson v. United States, 32 Fed. Cl. 709 (1995). Because the court did not err in determining that the Drobnys were not entitled to the asserted deductions and tax credits, we affirm.

DISCUSSION

In 1981 and 1982, the Drobnys claimed depreciation deductions, investment tax credits, and energy tax credits on their income tax returns. The claims were based on investments in alleged leveraged *[p. 2]* leases of solar energy equipment ("the Solargistics investment program").*/ The IRS denied

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*/ The details of the transactions involved in the Solargistics investment program are set forth in the Court of Federal Claims' decision.

the claims.

The Drobnys filed suit for a refund in the Court of Federal Claims. After an 8-day trial, the court denied the Drobnys' request for a refund. In particular, the court held:

> It was clear from the start that profits were not actually being made, and that profits were not the primary concern of those involved. Plaintiffs failed to prove the existence of a profit motive on their part. . . . At the time the transaction was entered into, however, an objectively reasonable possibility of making a profit did not exist, based on information available to the principals and to the plaintiffs. Therefore, the transaction lacked economic substance. For these reasons, the Solargistics-Geodesco program was a "sham."

Id. at 717. The Drobnys appeal.

We review the factual determinations underlying the court's decision that the Solargistics

investment program was a "sham" for clear error. Karr v. Commissioner, 924 F.2d 1018, 1023 (11th Cir. 1991), cert. denied, 502 U.S. 1082 (1992). However, we review de novo the legal standard applied in determining if the transaction was a "sham." Knetsch v. United States, 364 U.S. 361, 365 (1960); Karr, 924 F.2d at 1023.

On appeal, the Drobnys argue that the Solargistics investment program should be treated as a legitimate leveraged lease for federal income tax purposes. In support, the Drobnys argue that the facts of this case are "virtually identical" to the facts in *[p. 3]* Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995). In Sacks, the Ninth Circuit held that the taxpayer's

leveraged leases for similar solar heating equipment were not "sham" transactions for tax purposes. Thus, the Drobnys argue that we must reverse the court's decision that the Solargistics investment program was a "sham" transaction.

We disagree. "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists." Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985). Such a transaction is not entitled to tax recognition. E.g.,

Karr, 924 F.2d at 1023.

Here, the court properly looked to the circumstances surrounding the Solargistics investment program and determined that the transactions were "shams." Although the Drobnys' investments involved solar energy equipment similar to the equipment in Sacks, the underlying transactions were distinguishable. In particular, the court found that Solargistics' investment program was not a genuine multiple party transaction because "[t]here was no established lending institution that provided outside financing, nor were any of the companies involved in the investment program publicly held or recognized as established organizations with

experience in operating a business." Johnson, 32 Fed. Cl. at 713. *[p. 4]* Moreover, the court found that many of the solar heating units that investors purchased were not immediately leased to end users. Id. at 717. The court also found that an investor in the Solargistics investment program could select nonrecourse financing on the deferred portion of the equipment sales price. Id. at 725.

We discern no clear error in these findings. If the only expectation of profit is one based on tax deductions and credits, the transaction is not necessarily a sham. Profit is profit, and Congress intended the deductions and credits to induce investment. However, the Solargistics investment

program apparently only generated deductions and credits to shelter the Drobnys' other income. The Drobnys did not seem to purchase solar heating equipment to lease to customers for a profit, but rather, paid a fee in exchange for tax benefits. See Rice's Toyota, 752 F.2d at 95. The trial court's findings are not clearly erroneous. We therefore conclude that the court did not err when it found that the transaction had no practical economic effects because no reasonable possibility of a profit existed. Thus, the Solargistics investment program was a "sham" and the Drobnys were not entitled to a tax refund.

[dated May 29, 1996]

United States Court of Appeals
for the Federal Circuit

95-5084

SHELDON and ANITA DROBNY,

Plaintiffs-Appellants,

v.

THE UNITED STATES,

Defendant-Appellee.

O R D E R

Before NEWMAN, Circuit Judge, LOURIE, Circuit Judge, and SCHALL, Circuit Judge.

A petition for rehearing having been filed by the APPELLANT,

UPON CONSIDERATION THEREOF, it is

ORDERED that the petition for rehearing be, and the same hereby is, DENIED.

The mandate of the court will issue on June 3, 1996 unless another time

becomes appropriate under Rule 41.

FOR THE COURT,
FRANCIS X. GINDHART, CLERK

Dated May 29, 1996

by *(signature)*
Brian P. LeDuc
Associate Chief Deputy Clerk

cc: SHELDON DROBNY
GARY R. ALLEN

FILED
U.S. COURT OF APPEALS FOR
THE FEDERAL CIRCUIT
MAY 29, 1996
FRANCIS X. GINDHART
CLERK

DROBNY V US, 95-5084
(CFC - 343-89T)

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* Note: Pursuant to Fed. Cir. R.
* 47.6, this order is not citable as
* precedent. It is a public record.
*
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In the United States Court
of Federal Claims

Consolidated Docket Nos.
267-89T
274-89T
343-89T
482-89T
90-508T
91-1017T

(Filed: February 15, 1995)

DEBORAH L. JOHNSON, et al.	Income Tax Refund; Depreciation Deductions; Investment Tax Credit; Energy Tax Credit; Solar Energy Equipment; Leveraged Leases.
v.	
THE UNITED STATES	

Fred R. Harbecke, Chicago, Ill., attorney of record for plaintiffs.

Robert Stoddart, Washington, D.C., with whom was Assistant Attorney General *Loretta C. Argrett*, for defendant.

OPINION

HARKINS, Senior Judge:

Plaintiffs in these six consolidated

cases seek refunds of income taxes. Their income tax reports claimed depreciation deductions, investment tax credits, and energy tax credits, from investments in programs that involved so-called leveraged leasing of solar energy equipment. The depreciation deductions and tax credits were disallowed, the additional assessments have been paid, and the claims for refunds have been denied.

The complaints identified 161 individuals in a numbered list of 87 plaintiffs, 74 of which involved joint returns filed by husband and wife and 13 were individuals. The solar energy *[p. 2]* investment program was active from 1981 through 1985. Tax years relevant to plaintiffs' claims are 1982,

1983, 1984, and 1985. Some of the initial plaintiffs have been dismissed by stipulation. Appendix A lists the remaining plaintiffs by name, investment year and number of units purchased. Plaintiffs' claims were the subject of an 8-day trial during the period from July 26 to August 4, 1993. Posttrial briefing was concluded on April 7, 1994. Plaintiffs' proposed findings of fact were numbered 1 to 311; defendant's proposed findings of fact were numbered 1 to 363. On March 12, 1993, the parties filed a joint stipulation of fact that contained five items, which was adopted in the order closing proof. Appendix B lists facts that control the disposition of plaintiffs' claims.

Plaintiffs, as a group, include

CPAs, securities brokers/dealers, securities representatives, insurance brokers, and other professionals. In the relevant years, many possessed investment portfolios, all were sophisticated investors. The solar energy program in which they invested was started in 1981 to take advantage of business opportunities foreseen to accompany rising energy costs and tax incentives designed to promote investments in alternative energy sources. The investment program was controlled and operated by seven individuals who were the principal officers in two corporations located in Northbrook, Illinois, Solargistics Corporation (Solargistics) and Geodesco, Inc. (Geodesco).

All four of the principal officers active in Solargistics were CPAs, three had been employees of the IRS, and one also was an attorney. Of the three principals in Geodesco, one was an attorney, two had backgrounds in operating a business as well as some knowledge of the solar energy industry.

Operations in the investment program did not involve many employees. In 1982, Solargistics had three full-time employees in the Northbrook office, and Geodesco had 10 to 15 full-time employees. Geodesco operated through dealerships, which were responsible for their own employees.

Organization and operations of the investment program did not require full time attention of the two promoters,

each of whom owned 50 percent of Solargistics shares, acted as its officers, and were its sole directors. One devoted 20-25 hours per week in 1982, and 15 hours per week in 1983 and 1984; the other devoted 10-20 hours per week Spring 1982, 40-60 hours per week in Fall 1982, 25-30 hours per week during 1983, and full time for both Solargistics and Geodesco during 1984. Each received compensation of approximately $60,000 in 1982 and $30,000 in 1983.

Solargistics' promotional materials, Equipment Brochures and Transaction Summaries, described investment credit and depreciation allowances, with emphasis on income tax benefits. The 1982 summary stated that

for a net cash outlay of $5,600, with no further surviving personal obligation, the equipment transaction would produce an effective tax writeoff of $15,600. The 1983 summary stated that for a net cash outlay of $6,500 in 1983, and $800 in 1984, with no *[p. 3]* future outlay, the equipment transaction would produce an effective tax writeoff of $16,125 during the year of purchase. The summary for 1984 asserted the same benefits. The promotional materials for 1982 and 1983 were written by the person that had organized Solargistics and Geodesco.

Solargistics' investment program was designed as a leveraged leasing vehicle. The purchase documents required to be executed with initial

payment included: (1) Purchase Agreement; (2) Equipment Rental Agreement; (3) Option Agreement; (4) Assignment of Option Premium Proceeds; and (5) Maintenance Agreement. The promotional brochures described the transaction as a purchase of solar equipment from a manufacturer, through Solargistics, with 75 percent of the purchase price financed by the manufacturer, through Solargistics. The purchase was subject to a lease of the equipment to Geodesco and a rental agreement with Geodesco. The lessee would sublease to end users, and remain liable to the investor on the rental contract. This arrangement, however, does not conform to the approved type of leveraged equipment lease that had

developed in the 1970s and was recognized as acceptable business techniques.

Sheldon Drobny, a principal in Solargistics' organization and operations, testified that the arrangement did not represent either a simple leveraged leasing transaction nor a complex leveraged leasing transaction such as were depicted schematically in 1988 CCH Tax Transactions Library, Equipment Leasing: Vol. 2, ¶12.01. Mr. Drobny used these diagrams as a testimonial aid.

Rev. Proc. 75-21, 1975-1 C.B. 715, sets forth guidelines used by the IRS to determine whether certain transactions purporting to be leases of property are, in fact, leases for income tax purposes.

Solargistics' program was not submitted to the IRS for an advance ruling. The type of transaction covered by the IRS procedure, commonly called a "leveraged lease," was described:

> Such a lease transaction generally involves three parties: a lessor, a lessee and a lender to the lessor. In general, these leases are net leases, the lease term covers a substantial part of the useful life of the leased property, and the lessee's payments to the lessor are sufficient to discharge the lessor's payments to the lender.

Id. at 715.

In the 1970s, equipment leasing became an established service industry for a variety of capital goods, ranging from jet planes, railroad cars, automobiles, computers, special industry machinery, to miscellaneous capital goods such as restaurant equipment. Government publications noted equipment

leasing accounted for 15 percent of capital investment spending in 1976, and the volume was expected to continue upward to accompany market developments. In the Commerce Department publication, a leveraged lease was defined:

> A lease in which the lessor borrows a portion of the purchase price *[p. 4]* of the leased equipment from institutional investors. In a typical transaction, 20 to 40% of the purchase price is provided by one or more investors who become owners and lessors of the equipment. The balance of the purchase price is borrowed from institutional investors on a non-recourse basis to the owner. The borrowing is secured by a first lien on the equipment, an assignment of the lease, and an assignment of the lease rental payments. A leveraged lease may also refer to transactions in which a lessor finances equipment to be leased by borrowing from a bank or some other lending agency, using the lease and equipment as security.

BUREAU OF DOMESTIC COMMERCE, U.S. DEPT. OF COMMERCE, EQUIPMENT LEASING AND RENTAL INDUSTRIES: TRENDS AND PROSPECTS 26 (1976).

The leasing program undertaken by

Solargistics and Geodesco departs significantly from these definitions of a typical leveraged lease. One difference is the absence of a third party as the source of financing for the balance of the purchase price of the equipment. Other differences include: the attenuated course, from end user to installer to Geodesco to investor, of money needed to recoup the original cash investment and payment of the obligation to the lender; Solargistics acting as both the manufacturer and the lender, and Geodesco's multiple functions as a lessee.

On April 30, 1983, Solargistics made a rescission offer to investors who had purchased solar energy equipment packages and had executed the purchase

documents in the Solargistics 1981 program and 1982 program. The rescission offer was stated to be a precaution to assure the programs had not been sold in violation of the securities laws. The offer of rescission recognized that Solargistics was the lender and that material parties included divisions of Geodesco. The Rescission Offer stated:

> Under the 1982 Program, 75% of the purchase price of the 1982 Equipment was financed (non-recourse) by Solargistics at an annual interest rate of 9% for 10 years. Each system so purchased was already subject to a 3 year equipment rental agreement with Geodesco, Inc., as lessee, which provided, among other things, for: a $2,487.30 annual rental and a $2,500 rental termination equipment removal fee to be paid by the lessee to the Purchaser following the termination of the equipment rental agreement.

* * * * *

The material parties involved in

Solargistics 1981 Program and 1982 Program are Solargistics Corporation, Geodesco, Inc., Geodesco Finance Company, Geodesco Lease Company and Geodesco Energy Services. *[p. 5]*

* * * * *

Geodesco is primarily engaged in the business of procuring by lease, distributing, supplying and subleasing solar energy equipment. In this capacity, Geodesco leases, and in turn supplies and subleases such equipment (directly or through one of its divisions such as Geodesco Lease Company) and it also frequently arranges and/or provides financing for persons who purchase such equipment (directly or through one of its divisions such as Geodesco Finance Company).

* * * * *

Geodesco Finance Company

Geodesco Finance Company ("Geodesco Finance") is a division of Geodesco. As part of the 1981 Program, Geodesco Finance provided Purchasers with financing for up to 80% (75% non-recourse, 5% with recourse) of the purchase price of the 1981 Equipment at an interest rate of 9% per annum for slightly in excess of 10 years. (See "the 1981 Program").

Geodesco Lease Company

Geodesco Lease Company ("Geodesco Lease") is a division of Geodesco. Pursuant to the 1981 Program, Geodesco Lease was the lessee of the solar energy equipment (purchased by Purchasers) and in turn supplied or subleased such equipment to the end-users. (See: "Geodesco, Inc." and "The 1981 Program.")

Geodesco Energy Services

Geodesco Energy Services ("GES") is a division of Geodesco. Pursuant to the 1982 Program, GES has been responsible for generating leads for leases and actual installation of the systems on the facilities of end-users. GES affords Geodesco closer control over the sales and installation of the systems.

Protections provided to an equipment buyer in a normal leveraged lease by a third party lender, and clearly defined responsibilities of the lessee, were combined and muddled in the Solargistics-Geodesco program. There was no established lending institution

that provided outside financing, nor were any of the companies involved in the investment program publicly held or recognized as established organizations with experience in operating a business. Small companies with limited resources, whose few shares are owned solely by one or two individuals *[p. 6]* and operated jointly by a narrow group of promoters, are not capable of providing the protections to an investor that are expected in an approved leveraged lease vehicle.

Plaintiffs argue that although Solargistics and Geodesco were mutually dependent, Geodesco was a separate entity, having shareholders, officers, and directors different than those of Solargistics. This argument disregards

the functions provided by Drobny and Carpenter, by the pervasive mutuality provided through the management committee, and by the interchange where officers and directors of Solargistics worked for Geodesco, and officers and directors of Geodesco worked for Solargistics. Any recognition of separate and distinct corporate identities would require the actual acts of Solargistics-Geodesco's operations to be ignored. Blind acceptance of plaintiffs' argument would give legitimacy to misuse of corporate powers breathed by one of the promoters into a corporate shell that had been held on the shelf for an attorney's client.

Adjudication of income tax claims long has recognized application of the

doctrine of substance over form. The simple expedient of drawing up papers does not control for tax purposes when objective economic realities are to the contrary. *Commissioner v. Tower*, 327 U.S. 280, 291 (1946). In the field of taxation, the concern is with substance and realities, formalities are not rigidly controlling. *Helvering v. Lazarus & Co.*, 308 U.S. 252, 255 (1939).

Defendant does not contest plaintiffs' argument that Solargistics could have applied for, and received, a private letter ruling under Rev. Proc 75-21 that would have recognized the transactions as leveraged leases. Defendant contends, however, that such recognition would not provide a "safe harbor" for the program because,

although the plaintiffs owned the uninstalled components they bought, the evidence shows the purchase was for tax benefits, not for promised rent payments.

Absence of a clear third party in the transaction raises the question of whether the equipment buyer merely provides financing, while the seller in effect sells tax benefits, as in a sale-leaseback transaction. *See Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Sacks v. Commissioner*, 64 T.C.M. (CCH) 1003 (1992). Plaintiffs argue that the Solargistics-Geodesco program is comparable to the solar energy transactions leveraged lease programs considered by the Tax Court in *Cooper v. Commissioner*, 88 T.C. 84 (1987), and

Wood v. Commissioner, 61 T.C.M. (CCH) 2571 (1991). These cases, however, involved transactions that were considerably different from the Solargistics Geodesco operations. Plaintiffs recognized these differences: in *Cooper*, the investors purchased equipment directly from the manufacturer, in the Solargistics program, the equipment was purchased from the manufacturers by Solargistics and then sold to the investors; unlike the transactions in *Wood*, which involved only a single manufacturer, Solargistics purchased equipment directly from various manufacturers; unlike the *Cooper* program, Solargistics-Geodesco did not require the investors to enter

accounting arrangements, nor did it require a management agreement, as in the *Wood* program. Additional structural differences from the *Cooper* and *Wood* programs, according to plaintiffs, were: the investor in the Solargistics-Geodesco program purchased a complete system ready to install, the cost of which was paid by Solargistics; in *Wood*, the purchase agreement did not provide for installation, *[p. 7]* which was the responsibility of the lease company.

The crux of plaintiffs' argument that the Solargistics-Geodesco program was a multiple party transaction is that the leasing entity at all times purportedly had an existence separate and distinct from that of the selling entity. To support the distinct entity

concept, plaintiffs rely on the separate stock ownership of Solargistics and Geodesco, the absence of interlocking directorates, and the assertedly separate conduct of each company's respective businesses. These arguments are without merit. Plaintiffs' transactions, while not a true sale-leaseback, involved only two parties.

The issue thus becomes, whether plaintiffs' solar energy investments, for income tax purposes, were a sham. It is well settled that taxpayers are free to structure their transactions so as to decrease or eliminate their taxes by any means permitted by law. *Gregory v. Helvering*, 293 U.S. 465 (1935). Tax benefits, however, will not be allowed if the transaction is illusory. A

transaction must be given its affect *[sic.]* in accord with what actually occurred. *Frank Lyon Co.*, 435 U.S. at 576.

"To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists." *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985). "[C]ourts should examine, carefully and warily, attempts to use the tax system to obtain a benefit or advantage where the only possibility of any real benefit or advantage comes through the tax

mechanism itself. . . ." *Brown v. United States*, 426 F.2d 355, 356 (Ct.Cl. 1970).

Profit Motive

Defendant contends plaintiffs are not eligible for deductions in the year of purchase because they lacked a profit motive. Section 183(a) of the IRC*/ limits deductions attributable to an activity "not engaged in for profit." Section 183(c) defines an "activity not engaged in for profit" as "any activity other than one with respect to which deductions are allowable for the taxable year under" IRC § 162 (ordinary and necessary expenses incurred in carrying

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*/ All references are to Internal Revenue Code of 1954, as amended to the relevant years.

on any trade or business), or under paragraph (1) or (2) of IRC § 212 (expenses for (1) the production and collection of income; and (2) management of property held for the production of income). Where taxpayers engage in an activity without the requisite profit motive, deductions are available only to the extent that the gross income derived from such activity for the taxable year exceeds deductions that are allowable despite a lack of profit motive, e.g. deductions allowable under the IRC other than IRC § § 162 and 212. *See* IRC § 183(b).

Taxpayers must show that profit was their primary motive if they claim to be engaged in a trade or business. "We accept the fact that to be engaged in a

trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary *[p. 8]* purpose for engaging in the activity must be for income or profit." *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987).

In this case, unless the investments were engaged in for profit, plaintiffs are entitled to no deductions. To prove that a profit motive existed, plaintiffs must show that the transaction was "entered into, in good faith, with the dominant hope and intent of realizing a profit, i.e., taxable income, therefrom." *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963).

Treas. Reg. § 1.183-2(a) provides:

"[t]he determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case." Treas. Reg. § 1.183-2(b) provides a non-exhaustive list of nine factors that "should normally be taken into account" to determine if a taxpayer had a profit motive. The factors are the following: (1) the manner in which the taxpayer carries on the activity, particularly with regard to whether the activities are carried out in a business-like manner or similar to other profitable endeavors; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) an

expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer, in that it shows the motive of the taxpayer and his/her personal need for profits; (9) elements of personal pleasure or recreation, which may indicate a non-profit motive.

These factors are criteria that apply to determination of an investor's profit directed motivation. The motivation of the principal officers that promoted the Solargistics-Geodesco

investment program clearly was profit oriented. The Regulation's criteria, however, is not a test of the promoters' motives, and analysis of their operations per se is not transferrable to the plaintiffs.

Application of the Treas. Reg. § 1.183-2(b) factors to the plaintiffs in these consolidated cases shows:

1. *Manner in which the taxpayer carries on the activity.* There is no evidence that any plaintiff kept records of their equipment purchase leasing activities, or the ultimate location of their solar equipment after it was purchased. Plaintiffs entrusted the leasing business to Solargistics and Geodesco. Passive investment and delegation of business responsibility to

others do not constitute a trade or business. *Smith v. Commissioner*, 91 T.C. 733, 764 (1988), *aff'd sub nom. Karr v. Commissioner*, 924 F.2d 1018 (11th Cir. 1991), *cert. denied*, 112 S.Ct. 992 (1992).

2. *The expertise of the taxpayer or his advisors.* There is no indication that plaintiffs undertook independent studies or consulted with experts prior to investing. Plaintiffs relied upon the expertise of the principals, Solargistics' brochures and transaction summaries. With one exception (Drobny) all of the plaintiffs relied upon the principals of the involved companies to *[p. 9]* conduct day to day operations. Reliance on principals, whose primary areas of experience involved accounting,

investment and tax law, and the reliance on the promotional literature shows a concern for tax benefits, not profits.

3. *The time and effort expended by the taxpayer in carrying on the activity.* For the most part, the leasing activities were not personally carried out by the investors. The principals of Solargistics and Geodesco were responsible under the program for such activities. In practice, once the transaction documents were signed, the plaintiffs' tasks were completed. There is no evidence that the plaintiffs themselves, other than Drobny, devoted any time to finding end users for their equipment.

4. *Expectation that assets used in the activity may appreciate in value.*

The plaintiffs sold their lessees an option to purchase the equipment at the end of the lease term. Even if the equipment did appreciate, the plaintiffs could not profit from the appreciation.

5. *The success of the taxpayer in carrying on other similar or dissimilar activities.* Plaintiffs did not prove that any plaintiffs had experience with other equipment leasing activities.

6. *The taxpayer's history of income or losses with respect to the activity.* and 7. *The amount of occasional profits, if any, which are earned.* In none of the program years before the court did the plaintiffs receive the rental payments owed to them by the leasing companies. Despite the knowledge that profits had not actually

been forthcoming during the previous years' programs, some plaintiffs continued to purchase the equipment. This indicates that their motives were other than profit-oriented.

8. *The financial status of the taxpayer.* The purpose of this inquiry is to determine the taxpayer's need for income, as an indication of its desire for profits. Investors in the 1983 and 1984 programs were required to warrant that they had a net worth of at least $100,000. While $100,000 is not such a substantial amount as to limit the program to those who do not need additional income, it does suggest that involvement in the program was not intended to be an investor's primary profit-making endeavor.

9. *Elements of personal pleasure or recreation.* Many of the principals, and some of the plaintiffs, professed a commitment to development of alternative sources of energy. There is no indication, however, that any had such commitment that it amounted to "personal pleasure."

There are additional facts that require the conclusion that plaintiffs lacked a true profit motive and that the transactions were entered into to obtain tax benefits. Despite the leasing companies, failure to pay rent during all three years of the program, none of the equipment owners sought any of the remedies provided for in the Equipment Rental Agreement. Upon termination of the program, none of the plaintiffs

attempted to physically retrieve their property. In summary, an application of the factors set out in Treas. Reg. § 1.183-2(b), particularly with regard to the historical absence of profits, demonstrates plaintiffs' primary motive was other than *[p. 10]* for profit.

Plaintiffs had no profit motive and can claim no depreciation or other "trade or business" deductions in the year of purchase. Under these circumstances, plaintiffs can claim no tax credits for placing property in service in a trade or business, because they had no "trade or business" within the meaning of the Code. Plaintiffs argue that the solar energy equipment was property eligible for tax credits as well as for depreciation deductions.

IRC § 48 property, however, includes only property "with respect to which depreciation . . . is allowable" under § 167(a) (applied to "recovery property" by § 168(a)). IRC § 48(a)(3)(C). IRC § 167(a) allows depreciation only for exhaustion "(1) of property used in the trade or business, or (2) of property held for the production of income." The taxpayers' right to both depreciation deductions under § 167(a) and investment tax credits under § 48(a)(1) is contingent upon showing that their activities constituted either a trade or business or were undertaken and carried on for the production of income. *Rose v. Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989).

Economic Substance

Generally, transactions that have no economic significance other than anticipated tax benefits are considered illusory and tax benefits are denied. *See Falsetti v. Commissioner*, 85 T.C. 332 (1985); *Brown v. Commissioner*, 85 T.C. 968 (1985). A transaction lacks economic substance if no "reasonable possibility of profit from the transaction existed apart from tax benefits." *Rice's Toyota World, Inc.*, 752 F.2d at 94.

The determination of whether a transaction has economic substance is essentially a two part analysis: (1) whether the substance of the transaction is reflected in its form, and (2) whether the transaction had a reasonable objective possibility of providing a

profit aside from tax benefits.

Much of the trial record and posttrial briefing is concerned with examination of the first part of the analysis -- substance as reflected in form. To support their contentions that the Solargistics-Geodesco program had economic substance, plaintiffs emphasize two authorities. Plaintiffs rely upon the analysis in *Cooper*, 88 T.C. at 104, of the passage of the burdens and benefits of ownership to a putative purchaser. This analysis involved determination of a bona fide sale by application of the eight factors[1]

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[1] (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a

enunciated in *Grodt v. McKay Realty Inc. v. Commissioner*, 77 T.C. 1221 (1981). Plaintiffs also rely on the argument that the program allegedly complied with Rev. Proc. 75-21, which thus provided a safe harbor. These arguments, *[p. 11]* even if in accord with the facts, go only to the "substance as reflected in form" part of the analysis. It is not necessary to examine in detail the various contentions of the parties on those matters because plaintiffs clearly fail the second part of the economic

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present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. *Grodt & McKay Realty Inc.*, 77 T.C. at 1237-38 (citations omitted).

substance analysis whether a reasonable possibility of making a profit existed.

Even if everything were to go according to plan, the 1982 program only projected a net positive cash flow of $1,400 over 10 years. The 1983 and 1984 programs both projected a net profit cash flow of $3,000. Furthermore, at the time the 1982, 1983, and 1984 investors purchased their units, which was generally at the end of each year, information was available to the principals, in the role of agents to the purchasers, regarding the success of previous leasing activities in the solar energy market. In the 1982 program, the brochure indicated that as of September 1982, many systems remained unplaced from the previous year's program, and

additionally, that there was no assurance that Geodesco would be able to meet its obligations to the investors. Similarly, during 1983 and 1984, the principals were aware, and the investors specifically were informed, that many systems remained unplaced and that Geodesco had defaulted on its rental payments. The information most pertinent to their investment decisions, the program brochures, indicated a lack of profit for investors. With regard to any objective reasonability of profit, the transactions were without economic substance.

"The law is well settled that tax deductions and credits are a matter of legislative grace and the burden of showing clearly the right to the claimed

credits is on the taxpayer." *Segel v. Commissioner*, 89 T.C. 816, 842 (1987) (citing *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943)). Plaintiffs delegated the majority of the business activities to the principals of the involved companies. These principals primarily were concerned and experienced with tax and accounting matters, rather than the operation of a leveraged leasing business. It was clear from the start that profits were not actually being made, and that profits were not the primary concern of those involved. Plaintiffs failed to prove the existence of a profit motive on their part. With regard to the economic substance of the transaction, the formalities of the sale and lease

likely could be sufficient under the *Cooper* analysis. At the time the transaction was entered into, however, an objectively reasonable possibility of making a profit did not exist, based on information available to the principals and to the plaintiffs. Therefore, the transaction lacked economic substance. For these reasons, the Solargistics-Geodesco program was a "sham."

APPENDIX A

Plaintiff	Year	Units
Allen, Terry and Rita	1982	3
	1983	2
Ashkenasi, Shmuel and Mihaela	1982	1
	1983	1
Aston, James and Ann	1984	1
Barg, Mark and Michaelene	1983	3
Boho, Dan and Sheri	1984	1
Bond, Steven and Cynthia	1983	1
Carone, Robert	1982	1
	1983	1
	1984	1
Chai, Stanley and Sylvia	1982	2
Chestnut, William and Mary	1984	3
Cless, Gerhard and Ruth	1981	4
(KC Partnership: G. Cless 50%, E. Kaplan 50%)	1982	8
Cohodes, Barry and Randi	1982	1
	1983	1
Dachman, Carey and Gail	1983	1
Diamond, Louis and Marlene	1983	1

Plaintiff	Year	Units
Doyle, Joan	1981	1
and Estate of Robert	1982	1
Drobny, Sheldon	1981	5
and Anita	1982	6
*[p. 13]*Dumit, Thomas		
and Barbara	1983	1
Efferson, Narvin		
and Theresa	1982	1
Fitzgerald, John		
and Patricia	1983	1
Frishman, Alvin	1981	2
and Shirley	1982	1
	1983	1
Gardner, Edward		
and Ellen	1984	1
Garris, Estate		
of Arnold	1982	2
Garris, Joseph and Emma		1
(See A&J Investments)	1981	1
Geiger, Melvin		
and Marjorie	1983	1
George, Norman	1983	2
and Carolyn	1984	1
Gierlach, Richard	1984	1
Glustoff, Dale		
and Arlene	1982	1
Golan, Joseph and Hana	1981	3
	1982	1
	1983	2
Gold, Arthur and Ellyn	1981	1
	1982	2
	1983	2
Seigo & Co.	1981	.75
(A. Gold 75%, Robert	1982	.75
H. Siegle 25%	1984	.75

Plaintiff	Year	Units
Gore, Richard and	1981	2
Estate of Camille	1982	2
Harms, James	1982	1
Hartman, Michael	1981	1
and Debra	1982	2
	1983	1
[p. 14] Hason, Ronald	1981	1
and Mary	1982	1
Henoch, Michael	1982	1
and Louise	1983	1
Henry, Donald		
and Diane	1983	1
Hogenmiller, Rudolph	1981	1
Johnson, Deborah L.	1982	1
Kaplan, Edward and		
Carol		
(KC Partnership:		
G. Cless 50%,	1981	4
E. Kaplan 50%)	1982	8
Katlin, Frank and Fay	1981	3
	1982	2
Katlin, Jory and Jill	1982	2
Kolbe, Michael		
and Margaret	1983	1
Krone, Ronald and Ann	1982	1
	1983	2
Lane, Lee and Susan	1982	1
	1983	1
Linderman, Stuart	1982	3
and Andrea	1983	1
McKee, Mary		
and J. Cooper	1984	3
Macaluso, Sam		
and Barbara	1982	1
Meroni, John	1981	4
and Barbara	1982	4

Plaintiff	Year	Units
Miscimarra, Anthony and Lauren	1982	1
	1983	1
	1984	1
Morys, Joseph and Estate of Armella	1982	1
Myers, Phillip and Lynnetta	1982	1
	1983	1
Olshansky, Harold and Sheila	1981	3
	1982	2
[p. 15] Olshansky, Melvin and Roberta	1982	2
Payne, Frank and Mary	1981	1
	1982	2
Peters, Gordon	1981	2
	1982	2
	1983	2
Phee, Patrick and Kathleen	1983	1
	1984	2
Polivka, Kenneth and Camille	1982	1
	1983	1
Rocco, Estates of Thomas and Marie	1984	1
Rovinsky, Erven and Shirley	1983	3
Rundell, Stephen and Robin	1981	1
	1982	1
Russell, Kim (Howse)	1983	1
Sabransky, Jerry and Martha	1982	1
Sanders, David	1982	1
Schwartz, Neena	1981	1
	1983	1
Sherman, Robert and Sheila	1983	1
Silverman, Irving and Judith	1982	3

Plaintiff	Year	Units
Simons, Howard L.	1981	4
	1982	4
St. John, Daniel and Donna	1983	1
Stevenson, Ronald and Susan	1983	1
Swislow, Sidney and Ruth	1982	3
Swislow, Julius and Mary	1982	2
Teague, Henry and Ruby	1982	1
Trombello, Michael and Janice	1982	6
	1983	1
[p. 16] Turella, Frank	1983	1
Valerio, Frank and Annette	1982	5
Vartabedian, Gary and Mary	1983	1
	1984	1
Walker, William and Karen	1982	1
	1983	1
Wallace, Floyd and Susan	1984	1
Walters, David and Mary	1982	1
	1983	1
Weber, Frederick and Lynne	1983	1
Wolf, A. Alvin and Estate of Shirley	1982	1
Wolf, Ronald and Linda	1983	1
Woolf, David and Roslyn	1982	1
Zoghlin, Gilbert and Carolyn	1982	3
Zoldan, Jack and Sharon	1981	1
	1982	1
	1983	1

APPENDIX B

FINDINGS OF FACT

1. Plaintiffs are individuals, each of whom purchased equipment from Solargistics Corporation (Solargistics) either personally, or, in three instances as partners in general partnerships, during the years 1982 through 1984. Plaintiffs are knowledgeable in financial matters, many possessed investment portfolios, and all are sophisticated investors. Plaintiffs as a group include Certified Public Accountants (CPAs), securities broker/dealers, securities representatives, insurance brokers, and other professionals. *[p. 17]*

2. The investment program was

controlled and operated by the principal officers of Solargistics and Geodesco, Inc. (Geodesco).

3. Solargistics was an Illinois corporation engaged in the trade or business of selling solar energy heating equipment. The equipment sold by Solargistics, from 1981 through 1984, was solar energy property within the meaning of 26 U.S.C. § 48(1)(4)(B).

4. The original incorporator of Solargistics was Jay Gale (Gale), a businessman, working primarily in mergers and acquisitions. He is Randall S. Goulding's uncle. Randall S. Goulding (Goulding), a CPA and a licensed attorney, was a special agent and revenue agent with the Internal Revenue Service (IRS) from 1971 to 1978.

Solargistics was organized by Goulding on November 5, 1981. Goulding and Reuben Rosenberg (Rosenberg) each owned 50% of the shares of Solargistics, and acted as officers and its sole directors. Gerald Goldberg (Goldberg), the only other officer of Solargistics, became vice president in January 1983.

5. Prior to organizing Solargistics, Goulding was familiar with the tax benefits attributable to leveraged leases and to investment in solar energy equipment, including solar heating equipment. He had authored a study regarding such benefits and had clients involved in marketing and manufacturing such equipment.

6. Prior to organizing Solargistics, Rosenberg was a CPA and a

licensed securities dealer involved in estate and benefits planning, who had worked in government service in both the IRS and the Federal Energy Administration.

7. In addition to Goulding and Rosenberg, Sheldon Drobny (Drobny) was involved in organizing and structuring Solargistics' business. Drobny was a Certified Public Accountant having extensive experience in venture capital, business organization, tax and accounting, and in leveraged leasing.

8. Drobny from 1967 to 1971 was an employee of the IRS, with service in the audit and training divisions. In 1971, Drobny formed a CPA firm with Louis Adler (A&D) and was a partner in that firm from 1981 to 1984. Drobny devoted

20 hours per week in 1981 to Geodesco and Solargistics, 5-15 hours per week during 1982, and 15-20 hours per week during 1983. Drobny informally resigned in Spring 1983. Drobny never received any salary or commission. A&D did receive compensation for its accounting services during 1981-82.

9. Goldberg had a Bachelors degree in Commerce/Accounting, an M.B.A. in Finance, and was a CPA. Goldberg was first introduced to Solargistics by Rosenberg, and started as an independent contractor in 1982.

10. Geodesco was an Illinois corporation engaged in the trade or business of selling solar energy heating equipment, leasing such equipment from owners, locating end users for such

[p. 18] equipment, and installing and maintaining such equipment. Although organized by Goulding during 1980 as a shelf entity for a client, Geodesco was first utilized by Goulding during 1981.

11. In January 1982, Gerald Habinak (Habinak), Drobny, and A&D became Geodesco's shareholders, officers, and directors. Habinak brought to the operation business acumen, business experience, and ability to deal with leasing dealers and distributors. He had some knowledge of the solar industry. From January 1982, and until June 1984, Habinak and A&D remained the sole shareholders, and Habinak and Drobny remained the sole directors of Geodesco.

12. In 1982, William Speare

(Speare) became vice president of Geodesco, and in 1983 he became its president. Speare had a Bachelor's degree in Fine Arts with a major in architecture and was a master carpenter. Speare had started his own solar company, Advanced Solar Design, prior to working for Geodesco. Speare worked primarily full-time for Geodesco.

13. In 1984, Eldeen Carpenter (Carpenter) became the sole shareholder and director of Geodesco, and an officer; and in December 1985, upon Speare's resignation, Carpenter also became the sole officer of Geodesco. Carpenter had a Bachelor's degree in Medical Technology, a Master's degree in Social Work, and was a licensed attorney. Carpenter worked for

Goulding's law firm from 1982 through 1985.

14. Prior to organizing Solargistics, Goulding, Rosenberg, Drobny, and others on their behalf, including Gale, conducted market analysis related to the sale, lease, and financing of solar energy heating equipment. During 1981, after much research and analysis, Solargistics formulated a leasing program of its own. The 1981 Solargistics program provided for the equipment purchasers to lease the purchased equipment to Geodesco.

15. Solargistics marketed solar energy heating system leasing programs in each of 1981, 1982, 1983, and 1984, using equipment brochures and transaction summaries prepared by

Goulding in 1981 and 1982, and by Leonard Gerstein (Gerstein) in 1983 and 1984. From 1982 to 1984, Geodesco advertised the availability of the equipment for lease using newspaper advertisements, seminars, television, radio, the Yellow Pages, and direct telephone solicitations.

16. In the Spring of 1982, Solargistics had an office in Northbrook, Illinois and one full-time employee, and in the Fall of 1982, Solargistics hired two additional full-time employees, including Goldberg.

17. In the Spring of 1982, Geodesco had an office in Northbrook, and during 1982 and 1983, Geodesco opened four additional offices, two in Colorado and two in Florida. By 1983, Geodesco also

had dealerships in approximately ten states. In 1982, Geodesco hired Speare as a part-time employee, and later that year made him a full-time employee. During 1982, Geodesco hired approximately ten additional full-time employees, and during 1983, Geodesco *[p. 19]* had as many as 30 salespersons and independent contractors in Florida alone.

18. The Solargistics program was designed as a leveraged leasing program: (a) The investor purchased solar energy equipment through Solargistics acting as the manufacturer or nanufacturer' representative; (b) Solargistics provided financing in the form of deferred payments; (c) With the purchase of a unit of equipment from

Solargistics, the investors executed a Purchase Agreement provided by Solargistics; (d) Each investor agreed to a prearranged lease and rental agreement with Geodesco or a Geodesco company, which was obligated to place the equipment with end users, and remained liable for rental payments to the investor. In 1982 and 1984, all of the investor-owners leased this equipment to Geodesco. In 1983, three alternate leasing companies were potential lessees, Solarquest, Inc., Sun-Ergize Corp., and Geodesco Energy Services, Inc. (GES).

19. During the 1982-84 programs, Solargistics charged $20,000 per unit of equipment to investors, which included two to five solar systems. A $5,000

down payment was required, with the remaining $15,000 being deferred payments. The purchase price was received solely by Solargistics, not Geodesco.

20. The leasing program was structured such that Solargistics would receive income from the deferred portion of the sales price of the equipment. Geodesco would receive income from placement fees to be paid by Solargistics under a Purchase, Installation and Maintenance Agreement. Solargistics' profit was to come from payments by the investors of the $15,000 financed in the equipment purchase. These payments were to be made by Geodesco, on behalf of the purchasers, based on the rents it collected on the

leased equipment. Solargistics' profit was totally dependent on successful leasing and rental payments by Geodesco.

21. Geodesco's profit was to come from rent paid by end users (homeowners), and from a fee paid by Solargistics for placement of the equipment. Under its Purchase, Installation, and Maintenance agreement with Solargistics, Geodesco would not begin to earn installation fees for 1982 equipment until it had installed 50 percent of the units. After installing 50 percent of the units, Geodesco would receive approximately 1.5 percent of the installation fee owed. In 1981, Solargistics sold 304 units of solar equipment to investors. As of February 26, 1982, only 90 systems actually had

been placed on end users' homes.

22. Solargistics and Geodesco were dependent upon each other in order to profit from the Solargistics programs. Solargistics was dependent upon successful leasing of the equipment by Geodesco to end users in order for the investor-owners to pay the deferred portion of the sales price.

23. Geodesco was dependent upon Solargistics for a source of equipment which Geodesco could in turn lease to end users, and for working capital. Throughout 1982, 1983, and 1984, Solargistics loaned funds to Geodesco. *[p. 20]*

24. As a result of their interdependence, the officers and directors of Solargistics and Geodesco

were required to, and did in fact, work closely together. Beginning in 1982, and until problems arose between the principals and Habinak during 1983, a Management Committee consisting of Goulding, Rosenberg, Habinak, Drobny, and Goldberg, met at least weekly. During 1984, the Management Committee, without Habinak and Drobny, continued to meet weekly with Carpenter participating. As a result of their interdependence, officers and directors of Solargistics often worked for Geodesco, and officers and directors of Geodesco often worked for Solargistics.

25. Solargistics' 1982 brochure described the tax benefits from the program as 2.8:1 for 1982, up to 5:1 cumulative through 1986. Solargistics'

1983 brochure described the tax benefits from the program as 2.5:1 for 1983, and 4:1 in 1984. Solargistics' 1984 brochure described the tax benefits from the program as 2.5:1 for 1984, and 4:1 in 1985.

26. Solargistics' programs provided that the deferred portion of the equipment sales price was either recourse or nonrecourse, at the option of the purchaser.

27. The 1982, 1983, and 1984 programs each provided that upon any event of default, the purchaser had the right to terminate the lease and declare due, sue for, and receive from the lessee (1) all rents due and owing; (2) all rents that might later become payable under the lease; and (3) $1,000

as liquidated damages. In all three programs, the lease contracts included among events of default, a failure to pay rent for a period of 30 days after the rent fell due.

28. Solargistics' equipment sales took place primarily in the Fall of each year. Sales agents who sold Solargistics' equipment units received a commission of 10 percent of the cash sales price from Solargistics.

29. During 1981, Solargistics and Geodesco developed a 10-year business plan, which anticipated that Solargistics would sell and Geodesco would lease and find end users for 10,000 solar energy heating systems during that period, and that everyone involved would profit. Over the 10

years of the business plan, after both direct and indirect costs, Solargistics and Geodesco believed that Solargistics would earn $7 million before general and administrative expenses, which expenses would be approximately $100,000 to $200,000 per year. Over the 10 years of the business plan, after direct costs, but before operating expenses, Solargistics and Geodesco believed that Geodesco would earn $21 million.

30. From 1981 through the Fall of 1983, Solargistics and Geodesco believed that they could be more profitable and raise greater capital by making a public offering of Solargistics stock. They retained a securities law firm and requested it to prepare an initial public offering. The public offering

was abandoned in the Fall of 1983 after problems arose between the principals of Solargistics and Geodesco, and after the IRS commenced its audit of Solargistics. *[p. 21]*

31. During 1983 problems arose between the principals of Solargistics and Geodesco. Habinak created problems with suppliers and leasing personnel which the remaining principals decided had to be resolved. As a consequence of the Habinak matter, during 1983, Geodesco had to close certain leasing offices. The problems with Habinak were resolved in June 1984, when Habinak tendered return of his stock in Geodesco.

32. By the end of 1983, only 10 percent of the 1982 units had been

placed by Geodesco. By the end of 1984, only 25 percent of the 1982 units had been placed by Geodesco. Geodesco never received payments for installation of the 1982 program. To cover its operating costs, Solargistics lent money to Geodesco. Geodesco was to repay these loans with interest, and to secure the obligation by assigning its receivables to Solargistics.

33. Geodesco never received payments under the equipment rental agreements. Geodesco defaulted on the 1983 and 1984 programs when it failed to pay rent for a period of 30 days after it was due. Investors were specifically notified of this default. No plaintiff ever pursued any of the remedies for default allowed by the lease contracts.

Although, on December 1, 1987, Geodesco offered the investors the opportunity to retrieve their equipment and carry on their leasing business independently, all the plaintiffs chose to have their equipment liquidated, and Geodesco did liquidate all unplaced equipment that had not been lost.

34. Solargistics waived its lien and forgave the debt of $15,000 per unit that investors had incurred upon purchase of the equipment. After liquidation, Geodesco allowed plaintiffs to choose among the following ways of receiving the proceeds for each $20,000 unit: (1) membership in an organization that provided travel services; (2) discount credits from a mail order company; or (3) $80 cash. Geodesco

mailed out $80 to equipment owners, but some had relocated without leaving a forwarding address and were not capable of being located by Geodesco. The sums not able to be paid out were used by Geodesco to pay creditors.

35. Solargistics sold its equipment and the investors purchased the equipment at retail. Plaintiffs' solar energy equipment was permanently affixed to the homeowners' properties. This equipment could be removed with one to two days of work. Not all components could be removed, particularly the piping, and removal of the roof panels would leave holes in the roof that could only be repaired upon re-roofing. The useful life of the major components of the systems was from 20 to 30 years.

36. Before installation, Solargistics could not tell whether an investor's unit was comprised of five single panel systems or three two panel systems. Before 1985, Solargistics and the leasing companies had established no formal inventory control system to track equipment stored with manufacturers or sellers.

37. Solargistics had lost equipment belonging to investors through both bankruptcy of manufacturers and theft. The lost equipment was not recovered by Solargistics. The leasing *[p. 22]* companies were required to notify an investor if equipment was lost, stolen, or damaged, and, for the 1982-83 programs, to insure the equipment for $20,000 per unit. There is no evidence

of either an insurance policy taken out by Geodesco, or of any claims made.

38. In 1981, Solargistics purchased substantially all of its equipment from Solar Development, Inc. (SDI). During 1981, Solargistics sold approximately 304 units of equipment to approximately 180 purchasers for $20,000 per unit of equipment. All or substantially all of such equipment was subsequently installed on homes and residences in the Pacific Northwestern part of the United States by Geodesco through a dealership network that had been established by SDI.

39. Solargistics' 1982 brochure offered the sale for $20,000 of equipment that "could constitute one or more different types of wind or solar

energy systems. More specifically, it will be comprised of one large multi-paneled system or two or more, up to as many as six smaller hot-water heating systems." During 1982, there were sales only of water heating systems, primarily five-paneled.

40. The 1982 Solargistics program was designed as a leveraged leasing program, with the equipment purchaser buying equipment from Solargistics, and with Solargistics providing financing in the form of deferred payments. The equipment sold by Solargistics was subject to a preexisting lease with Geodesco, with the lease payments intended to be applied to the deferred purchase price, and with only minimal excess rentals being paid to the

purchaser until after the purchase price was fully paid.

41. In 1982, the Solargistics program required the purchaser to pay the following sums:

Purchase Price	$20,000
Down Payment	5,000
Deferred Payments	$15,000
Payable over 10 years with 9% interest	$2,337.30 per year
Maintenance Fee	$ 2,600
Down Payment	600
Balance Paid by Assign. of Option Premium	$ 2,000
Total Initial Payment	$ 5,600 *[p. 23]*

42. The financing was offered to purchasers with or without recourse. The equipment purchaser was required to pay a $2,600 first year maintenance fee per unit. Purchasers were only required to pay $600 of this amount down if they

elected to grant the end users of the equipment an option to purchase the equipment upon the earlier of 10 years or upon termination of the lease between the equipment purchaser and Geodesco for an aggregate of $3,000. In return for the option, the purchaser was paid an option premium of $2,000, which at the purchaser's election could be applied to offset the first year maintenance fee. The 1982 Solargistics program also provided for Geodesco to pay to the equipment purchaser a fee of $2,500, either upon termination of its lease, or as reimbursement of the cost of removing the purchaser's equipment from any building upon which it had been installed.

43. The 1982 Solargistics brochure

projected a positive cash flow of $7,000 per unit purchased, which, after the $5,600 due upon purchase, amounted to $1,400 net positive cash flow over a period of 10 years. The 1982 Solargistics program projected tax benefits of approximately $6,400 per unit of equipment based upon a 50 percent tax bracket.

44. The Purchase Agreement signed by each investor provided that each unit was subject to an Equipment Rental Agreement. The Equipment Rental Agreement provided in Item 24 that this Agreement is freely assignable, and that prior to the earlier of any assignment or

(b) the expiration of the thirty day period,

(i) the Owner is not entitled to use or otherwise enjoy any benefits hereunder,

(ii) the Equipment may not be used by either party hereto or otherwise, and

(iii) no rents shall be payable to the Owner and the Equipment shall not be placed in service.

45. Solargistics assigned its rights under its pre-existing lease to purchasers of units, but reserved for itself the right to receive the first $800 of rent per unit to be paid by the lessee, Geodesco.

46. During 1982, Solargistics sold approximately 473 units of solar equipment to approximately 264

purchasers, for $20,000 per unit.

47. In at least one instance, Geodesco held the equipment out for lease to an end user, Robert L. Ingle, before Solargistics sold it to the investor, Dale Glustoff.

48. Prior to December 31, 1982, Solargistics received from the various manufacturers with whom it had placed orders, written confirmation of the existence and location of the equipment. Prior to the installation of the equipment purchased by Solargistics and assigned to investors in 1982, the equipment was stored in inventory at the manufacturers' factories. *[p. 24]*

49. Under the 1982 program, the installment payments of $2,337.30 supposed to be made by Geodesco on

behalf of the equipment owners to Solargistics, were not made in cash, but only by entries on the books. The $150 payments owed to the equipment owners (after payment of the $2,337.30) were not made at all by Geodesco. Solargistics and Geodesco entered their 1982 lease agreement on November 1, 1982. All of the 1982 plaintiffs purchased their equipment more than 30 days after Solargistics and Geodesco entered their 1982 lease agreement. Some equipment that was part of the 1982 program was not actually manufactured until 1983. As of March 25, 1983, Geodesco had placed only 33 of the 1,521 systems that Solargistics had sold to its investors in 1982.

50. Solargistics' 1983 brochure

offered the sale for $20,000 of equipment that "could constitute two or more different types of wind or solar energy systems. More specifically, it will be comprised of two multi-paneled systems, or three to five, smaller hot-water heating systems." The 1983 Solargistics brochure offered the purchaser the opportunity to lease the equipment to Geodesco in 1983. In the complaints filed in this case and the claims for refund, the plaintiffs stated they were leasing their equipment to Geodesco during 1983.

51. In 1983, the Solargistics program required the purchaser to pay the following sums:

Purchase Price	$20,000
Down Payment	5,000
Deferred Payments	$15,000

Payable with 9% interest	$2,337.30 per year
Maintenance Fee	$ 3,500
Down Payment	1,500
Promissory Note	$ 2,000
Payable with 17.5% interest	$ 800 in 1984
Balance Due	$2,516.25 in 1988
Total Initial Payment	$ 6,500

52. In the 1983 Solargistics program, the first year maintenance fee was increased from $2,600 to $3,500 per unit of equipment. The program provided for the optional financing of a portion of the first year maintenance fee. Additionally, the 1983 program included a right of the lessee to exercise two separate options: (1) an option to extend the lease term; and (2) an option *[p. 25]* to purchase the equipment for a sum certain. The equipment owner would

be required to accept the exercise by the lessee of the option to extend the lease or purchase the equipment if the owner had accepted the option premium. The 1983 program required each investor to warrant that he had a net worth of at least $100,000. The financing was offered to purchasers with or without recourse.

53. In the 1983 promotional literature, Solargistics projected the following positive cash flow for the purchaser of one unit of equipment who leased such equipment to a leasing company under its program:

Annual Net Rental Income After Setoff for Promissory Note Payment and Annual Maintenance Charge	$ 152.70
	x 10
	$1,527.00
Estimated Rent for Remaining option Period	5,500.00

Option Exercise Price	3,150.00
Net Option Premium After Setoff for Maintenance Fee Loan	84.00
Positive Cash Flow	$10,261.00

54. In 1983, Solargistics projected that each purchaser would receive net positive cash flow over the initial term of the lease and the option term (a total of 12 years) of approximately $3,000 ($10,261 less $6,500 due in 1983 and less $800 due in 1984), a return of 141% over such period.

55. During 1983, Solargistics sold approximately 233 units of equipment to approximately 178 purchasers, for $20,000 per unit.

56. At the time they purchased their equipment, the investors did not actually know the name of their leasing

company. With regard to a leasing company, purchase documents were sometimes submitted in blank, and then a clerk in the Northbrook office would fill in the name of a lessee.

57. During 1983, Habinak worked principally in Colorado while Speare was in Florida running the sales operations. Goldberg worked full time and was vice president of Solargistics. He also assisted with the leasing activities of the program. Problems arose between Habinak and the rest of the Management Committee during 1983. On March 25, 1983, when the promoters were considering a 1983 program, they also considered hiring a consultant to reduce friction *[p. 26]* between members of the Management Committee. Habinak was

accused of embezzling an uncertain sum of money -- from $30,000 to $80,000. Habinak threatened to put Geodesco into receivership. At that time, Geodesco had many obligations that it could not meet.

58. Drobny informally resigned from Geodesco in the Spring of 1983, but continued to assist Solargistics and Geodesco as an accountant and tax advisor. Drobny retained his shares in Geodesco until June 1984. Habinak left the program in late 1983, but did not tender back his shares in Geodesco until the middle of 1984. Rosenberg took over Habinak's functions as head of Geodesco.

59. Because of the dispute with Habinak during 1983, Goulding and Rosenberg decided that they would no

longer recommend that the equipment that Solargistics sold to equipment purchasers be leased to Geodesco. During 1983, Goulding requested that Carpenter activate the new potential leasing entities, GES and Solarquest, to which the 1983 equipment purchasers would be referred.

60. The articles of incorporation for Solarquest and GES were filed with the Illinois Secretary of State on January 5, 1984. Carpenter obtained the permission of Alan Zech, on whose behalf Ginseng, Inc. (Ginseng) had been incorporated on May 13, 1983, to use Ginseng as a solar energy leasing company. Articles of Amendment were submitted on April 23, 1984, with regard to Ginseng, Inc. to change its name to

Sun-Ergize Corp.

61. All of the plaintiffs' leases were assigned to Solarquest, except for Arthur and Ellyn Gold and Ronald and Susan Stevenson, whose leases were assigned to Sun-Ergize (f/k/a Ginseng). The plaintiffs believed they were leasing their equipment to Geodesco. In 1983, Geodesco accepted no offers to lease equipment.

62. Speare believed the 1983 program equipment, which he did not begin leasing to end users until 1984, was being leased through Geodesco. Speare was paid by Geodesco, not by Solarquest, Sun-Ergize, or Ginseng. Prior to installation, the equipment purchased by Solargistics and assigned to equipment purchasers in 1983 was

stored in facilities controlled by Speare or at the manufacturers' factories, and when needed for installation was obtained and installed by Speare.

63. In 1983, Solarquest had no shareholders and no officers. Solarquest had no employees and owed no federal payroll taxes. Solarquest applied for a Federal Employer Identification Number on May 15, 1984, which was assigned on June 5, 1984. The Purchase, Installation, and Maintenance Agreement, under which Solarquest was to earn its fees for installation of the 1983 equipment was not executed. The Purchase, Installation, and Maintenance Agreement, under which Sun-Ergize was to earn its fees for installation of the

1983 equipment was not executed. Other than completion of articles of incorporation, the corporate formalities were not administered with regard to Solarquest and Sun-Ergize during 1983. During *[p. 27]* 1983, Solarquest, GES, and Ginseng did not have either officers or shareholders.

64. Carpenter was the sole shareholder of Solarquest on January 10, 1984. In 1986, after Carpenter had become Geodesco's sole shareholder, GES, Solarquest and Sun-Ergize were merged into Geodesco, Inc. Carpenter signed the articles of merger on their behalf.

65. Solargistics' 1984 program was essentially the same as its 1983 program, except for minor modifications to rental income, maintenance fee and

financing repayment schedules. The financing program was offered to the purchaser with or without recourse. The 1984 program required each investor to warrant that he had a net worth of at least $100,000.

66. In 1983, the Solargistics program required the purchaser to pay the following sums:

Purchase Price	$20,000
Down Payment	5,000
Deferred Payments	$15,000
Payable with 9% interest	$2,337.30 per year
Maintenance Fee	$ 3,500
Down Payment	1,500
Promissory Note	$ 2,000
Payable with 17.5% interest	$ 800 in 1984
Balance Due	$2,516.25 in 1988
Total Initial Payment	$ 6,500

67. Solargistics' 1984 brochure offered the purchaser the opportunity to lease the equipment to "at least four" lease companies known to Solargistics. The brochure also stated that, in 1984, Geodesco had defaulted in its rental obligations to all owners of solar equipment. The brochure informed potential investors that the three leasing companies, Solarquest, GES, and Sun-Ergize had been near totally unable to lease any of the 1983 equipment. All of the 1984 plaintiffs leased their equipment to Geodesco.

68. Solargistics' 1984 promotional brochure projected the following positive cash flow for the purchaser of one unit of equipment who leased such equipment to Geodesco: *[p. 28]*

Annual Net Rental Income After Setoff for Promissory Note Payment and Annual Maintenance Charge	$ 152.52
	x 10
	$ 1,525.20
Estimated Rental for Remaining Option Period	5,700.00
Option Exercise Price	3,150.00
Net Option Premium After Setoff for Maintenance Fee Loan	84.00
Positive Cash Flow	$10,459.20

69. Solargistics' projected positive cash flow of $10,459.20 assumed the option term was exercised (for a total of 12 years). Taking into account the $6,500 down payment and the $800 due in 1985 for the maintenance agreement, this resulted in a net positive cash flow of approximately $3,000.

70. During 1984, Solargistics sold approximately 124 units of equipment to

approximately 86 purchasers, for $20,000 per unit.

71. During 1985 Solargistics ceased doing business, and Geodesco ceased its efforts to locate additional end users. Speare resigned from Geodesco and Goldberg resigned from Solargistics both during the fall of 1985. In 1988, Geodesco liquidated all remaining unplaced equipment and distributed the proceeds to the equipment owners.

C O N C L U S I O N

On the basis of the foregoing, plaintiffs have not established their claims for depreciation deductions, investment tax credits, or energy tax credits. Plaintiffs are not entitled to refunds. The Clerk is directed to

dismiss the complaints. Costs to defendant.

{signed}

Kenneth R. Harkins, Senior Judge

(2)

Supreme Court
FILED
SEP 29 1996

No. 96-409

In the Supreme Court of the United States

OCTOBER TERM, 1996

SHELDON AND ANITA DROBNY, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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15 pp

QUESTION PRESENTED

Whether the putative purchase and lease of equipment in this case was a "sham" transaction lacking economic substance that is to be disregarded for federal income tax purposes.

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In the Supreme Court of the United States

OCTOBER TERM, 1996

No. 96-409

SHELDON AND ANITA DROBNY, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-8) is unpublished, but the decision is noted at 86 F.3d 1174 (Table). The opinion of the Court of Federal Claims (Pet. App. 11-104) is reported at 32 Fed. Cl. 709.

JURISDICTION

The judgment of the court of appeals was entered on April 10, 1996. The petition for rehearing was denied on May 29, 1996 (Pet. App. 9-10). The petition for a writ of certiorari was filed on August 27, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. Petitioner Sheldon Drobny was an officer of Solargistics Corporation. That company, along with Geodesco, Inc., promoted a solar energy equipment leasing program (the S-G program). That program sought to take advantage of the tax incentives that are designed to encourage investments in alternative energy sources (Pet. App. 14-15, 19, 62, 66-69). The two companies that promoted this program shared several officers and directors (*id.* at 60-64).

As part of its 1982 investment program, Solargistics purchased uninstalled solar energy equipment from the manufacturer. This equipment had a list price of $6,060 and was purchased by Solargistics for $3,635 (Def. Exhs. 41A, 41, at 1-3). Solargistics offered to sell this equipment to investors for $20,000, with a down payment of $5,000 and the balance to be financed over 10 years at 9 percent interest. The annual payment on the 10 year note was $2,337.30 per year (Pet. App. 84; Jt. Exh. 1A, at 1). As part of each sale, Solargistics was required to pre-arrange a lease of the equipment to Geodesco at an annual rental of $2,487.30 (Pet. App. 18, 69). Geodesco, in turn, was to sublease the equipment to end-users. From the annual rent to be paid by the end-users, Geodesco was to make the investor's annual deferred purchase price payment ($2,337.30) to Solargistics and pay the balance of $150 directly to the investors (*id.* at 70-71, 83-84).[1]

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[1] The program also called for the investors to pay a one-time maintenance fee of $2,600. If the purchaser elected to give the end-user the option to purchase the equipment at the end of the lease term, however, only $600 of the $2,600 was

The promotional materials for the S-G program emphasized the income tax benefits of the transaction. The materials stated that, for a net cash outlay of $5,600, and with no further personal obligation, the transaction would yield a tax write-off of $15,600 to an investor in the 50% bracket in the year of purchase and additional benefits in the following years (Pet. App. 16-17, 69-70, 73-74, 84).

b. On December 27, 1982, petitioners purchased six units of solar energy equipment from the S-G program (Pet. App. 55; Pl. Exh. 8, at 1). On their joint federal income tax return for that year, petitioners claimed an investment tax credit of $43, an energy tax credit of $131, depreciation of $18,000 and maintenance expense of $15,600—all stemming from their participation in the 1982 S-G program (Pl. Exh. 16, at 7).

Some equipment that was ostensibly part of the 1982 program was not actually manufactured until 1983 (Pet. App. 89). Geodesco placed only 2 percent of the 1,521 systems that Solargistics had sold to its investors in 1982 by March 25, 1983, only 10 percent of the systems by the end of 1983 and only 25 percent by the end of 1984 (*id.* at 77-78, 84, 89). Geodesco never received any payments under the equipment rental agreements (*id.* at 78). Geodesco failed to pay the investors any net rent and did not make the annual loan installment payments of $2,337.30 to Solargistics. Instead, book entries were made by Geodesco and Solargistics purporting to evidence such payments (*id.* at 89).

Geodesco announced its default before investors made their 1984 purchases. Although the lease agree-

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payable at the time of purchase (Pet. App. 84-85; Jt. Exh. 1A, at 2).

ment gave the investors certain rights in the event of Geodesco's default—including the right to sue for rents due, future rents and liquidated damages—no investor ever pursued any of these remedies (Pet. App. 78). Geodesco offered the investors the chance to retrieve the equipment and to carry on the leasing business directly with any end-users. All of the investors, however, chose to have the equipment liquidated (*id.* at 79). When Geodesco was liquidated in 1988, each investor received $80 in cash for each $20,000 solar equipment unit, and Solargistics waived its lien and forgave the debt of $15,000 per unit (*id.* at 80-81).

2. The Commissioner of Internal Revenue disallowed the deductions and credits that petitioners claimed with respect to their S-G investment and determined that a deficiency of tax of $55,676.70 existed. The Commissioner also determined that additions to tax for negligence under 26 U.S.C. 6653(a)(1) (1982) and for valuation overstatement under 26 U.S.C. 6659 (1982) should be imposed. Petitioners paid the tax and penalties and filed an administrative claim for refund, which was denied.

3. Petitioners and other investors in the S-G program then brought this suit for refund in the Court of Federal Claims. After a trial, the court concluded that petitioners and the other investors were not entitled to the deductions and credits they claimed. The court found that the S-G program did not constitute a typical leveraged lease because of the lack of a bona fide third party and the "pervasive mutuality" of Solargistics and Geodesco (Pet. App. 27-32). After examining all of the relevant facts and circumstances, the court determined that "[w]ith regard to any objective reasonability of profit, the transactions were

without economic substance" (*id.* at 51). The court concluded that "the Solargistics-Geodesco program was a 'sham'" and is therefore not to be recognized for income tax purposes (*id.* at 53).

4. The court of appeals affirmed (Pet. App. 1-8). The court concluded that the lower court had applied the correct legal standard in determining whether the program was a sham (*id.* at 5-6). The court further held that it could "discern no clear error" in the lower court's findings regarding the facts and circumstances surrounding the transactions at issue (*id.* at 7) and in its conclusion that the S-G program was a sham (*id.* at 8).

The court of appeals rejected petitioners' contention that this case is "virtually identical" to *Sacks* v. *Commissioner*, 69 F.3d 982 (1995), in which the Ninth Circuit had held that leveraged leases of solar heating equipment were not "sham" transactions for tax purposes (Pet. App. 5). The court explained that the underlying transactions in this case "were distinguishable" from those involved in *Sacks* (*id.* at 6). In this case, unlike in *Sacks*, petitioners did not purchase the "equipment to lease to customers for a profit, but rather, paid a fee in exchange for tax benefits" (*id.* at 8).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. It is fundamental that taxation turns upon the substance of a transaction, not its form. *Gregory* v. *Helvering*, 293 U.S. 465 (1935). As this Court has held in *Frank Lyon Co.* v. *United States*, 435 U.S. 561

(1978), courts are to honor the rights and duties agreed to by parties to "a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." *Id.* at 583-584.

Applying this Court's decision in *Frank Lyon*, the courts of appeals have focussed on whether the transaction had any practical economic effects other than the creation of income tax losses. See *Karr* v. *Commissioner*, 924 F.2d 1018, 1023 (11th Cir. 1991), cert. denied, 502 U.S. 1082 (1992); *Hines* v. *United States*, 912 F.2d 736, 739 (4th Cir. 1990); *Shriver* v. *Commissioner*, 899 F.2d 724, 727 (8th Cir. 1990); *Rose* v. *Commissioner*, 868 F.2d 851, 854 (6th Cir. 1989); *Sochin* v. *Commissioner*, 843 F.2d 351, 354 (9th Cir.), cert. denied, 488 U.S. 824 (1988). In making that determination, the courts examine the objective realities of the transaction—what was actually done, as opposed to what the parties purported to do. *Frank Lyon Co.* v. *United States*, 435 U.S. at 573; *Knetsch* v. *United States*, 364 U.S. 361, 366 (1960); *Gregory* v. *Helvering*, 293 U.S. at 469. See also *Dewees* v. *Commissioner*, 870 F.2d 21, 35 (1st Cir. 1989); *Kirchman* v. *Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989); *Yosha* v. *Commissioner*, 861 F.2d 494, 497 (7th Cir. 1988). When a transaction does not "appreciably affect * * * [the taxpayer's] beneficial interest except to reduce his tax" (*Knetsch* v. *United States*, 364 U.S. at 366), the transaction lacks economic substance and is disregarded for federal tax purposes (*Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 (1945)). This approach has consistently been

followed in cases in which purported lease transactions have been found to be shams that have no effect for tax purposes. *E.g.*, *Rink* v. *Commissioner*, 47 F.3d 168, 172-173 (6th Cir. 1995); *Casebeer* v. *Commissioner*, 909 F.2d 1360 (9th Cir. 1990); *Shriver* v. *Commissioner*, 899 F.2d 724 (8th Cir. 1990); *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 94 (4th Cir. 1985).

2. The courts below had ample grounds for concluding that the lease arrangements involved in this case did not represent a genuine multiparty transaction with economic substance. Although Solargistics and Geodesco were ostensibly separate entities, the network of contracts between them was so inextricably intertwined that they did not constitute bona fide, multiparty leveraged leases. For example, while a bona fide leveraged lease typically involves three independent parties, in this case there was no unrelated third party who provided the source of financing for the purchase price of the equipment (Pet. App. 22; see Rev. Proc. 75-21, 1975-1 C.B. 715). As the trial court noted, the "attenuated course, from end user to installer to Geodesco to investor, of money needed to recoup the original cash investment and payment of the obligation to the lender" (Pet. App. 22) gave the transaction the appearance of a house of cards. For example, Solargistics wore two hats, standing in the shoes of both the seller and the lender. Geodesco also assumed multiple functions as lessee and sublessor. As the trial court aptly observed, "[p]rotections provided to an equipment buyer in a normal leveraged lease by a third party lender, and clearly defined responsibilities of the lessee, were combined and muddled in the Solargistics-Geodesco program" (*id.* at 25). In concluding that a bona fide economic transaction

was absent in this case, the court emphasized that all of the transactions were controlled by small, closely-held companies with limited resources, whose shares were owned by one or two individuals and which were operated jointly by a "narrow group of promoters" (*id.* at 26).

The courts below were also correct in concluding that the transactions at issue lacked economic substance due to the absence of an objectively reasonable possibility of any profit aside from tax benefits. The record plainly reflects that the venture had no realistic possibility of generating a profit. Even under the most optimistic assumptions, the net positive cash flow could not exceed $1,400 over 10 years (Pet. App. 86). As the courts correctly concluded, this program was designed to reap tax benefits, not to generate any genuine economic return (*id.* at 73).

The highly-inflated, debt-financed purchase price of the equipment further indicated that the transactions lacked economic substance. Nonrecourse debt that greatly exceeds the value of the underlying asset is not treated as true debt for tax purposes because a borrower could prudently abandon the property rather than repay the debt. *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045, 1048-1049 (9th Cir. 1976). The use of a highly inflated price based on deferred debt that is *unlikely* to be repaid also indicates a lack of economic substance. *Gilbert* v. *Commissioner*, 53 T.C.M. (CCH) 461, 469 (1987), aff'd, 858 F.2d 744 (11th Cir. 1988) (Table); *Flowers* v. *Commissioner*, 80 T.C. 914, 937 (1983). In this case, three-quarters of the purchase price of each unit of equipment was paid by means of a note to be repaid solely from rents and with the equipment as the sole collateral (Pet. App. 84). The price investors were to

pay ($20,000) greatly exceeded not only the manufacturer's list price of $6,060 but, even to a greater extent, the price Solargistics actually paid for the equipment ($3,635). The debt that was created served no function other than to generate increased tax benefits.

3. The court of appeals correctly rejected (Pet. App. 6) petitioners' contention (Pet. 12) that the facts of this case are comparable to those of *Sacks* v. *Commissioner*, 69 F.3d 982 (9th Cir. 1995), rev'g 64 T.C.M. (CCH) 1003 (1992). Like this case, *Sacks* involved a sale and leaseback of equipment eligible for the energy credit. In *Sacks*, however, the price paid for the solar water heaters "was about the middle of the range of prices" for comparable equipment being sold directly to homeowners (64 T.C.M. (CCH) at 1008), notes the taxpayer gave in partial payment were recourse in form (*id.* at 1027) and the equipment was actually leased to homeowners (*id.* at 1029 n.15). The Tax Court found the arrangement in *Sacks* to be a sham because the anticipated cash flow had a negative present value over the life of the equipment. The Ninth Circuit reversed, however, noting that, unlike the typical tax shelter, no grossly inflated purchase price was involved and that, since the promissory notes were recourse in form, the taxpayer was personally liable for payment (69 F.3d at 988-990).[2]

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[2] Contrary to petitioners' contention (Pet. 21 n.4), the trial court in this case did not make any finding as to whether they purchased the equipment "on fair terms, at fair market value," as was true in *Sacks* (69 F.3d at 990). And, although the promotional materials may have advertised a net rent payment to the investors of $150 (annual rent of $2,487.30, less annual deferred purchase price of $2,337.30, which the court found to

As the court of appeals correctly concluded (Pet. App. 5-8), the present case is distinguishable from *Sacks*. In *Sacks*, unlike in the present case, there was no "pervasive mutuality" among the parties to the arrangement (Pet. App. 27). Nor, unlike in *Sacks*, was the program in this case operated as a genuine business. Unlike in *Sacks*, relatively little equipment involved in the S-G program was leased to end-users. Compare 69 F.3d at 988 with Pet. App. 7, 71-72, 77-78. And, unlike in *Sacks*, the record in this case does not even show that the equipment actually existed when it was ostensibly purchased. Compare 69 F.3d at 988 with Pet. App. 88-89. Moreover, the option that petitioners gave to purchase the solar equipment (Jt. Exh. 1, at 39-40)—a feature not present in *Sacks*—gave away the opportunity to reap any profit that could be realized from the underlying transactions. Thus, unlike the taxpayer in *Sacks*, petitioners cannot contend that the transactions at issue embodied any bona fide expectation of profit apart from tax benefits. See 69 F.3d at 988.

The court of appeals thus properly concluded that the decision in *Sacks* is inapposite because of the factual distinctions that exist between the two cases. That factual determination does not warrant further review.

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be "minimal" (Pet. App. 83)), Geodesco failed to pay the investors any net rent (*id.* at 88-89).

CONCLUSION

The petition for writ of certiorari should be denied.
Respectfully submitted.

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